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The Politics as Usual Tax Act of 2004

By Bob Underhill

Just in time for the elections, Congress rushed through a new tax bill which was signed by the President on October 22. All such bills contain politically-motivated handouts, although this one is literally brimming with them. (As an example—and we're not kidding—the bill contains a tax break for ceiling fan manufacturers. Will we, as voters, ever be able to stop this?) But there are a few worthwhile things that come from the Act. We'll review those that impact many of our clients here.

Sales tax is back

The Act ***restores the deduction for sales tax*** that was scrapped back in the Reagan Administration's 1986 Tax Reform Act. The '86 Act lowered individual income tax rates all the way down to 28% (from as high as 70% in the early '80s). The quid pro quo was the repeal or limitation of certain itemized deductions and other losses, such as the deduction for sales tax and consumer interest. In a long-overdue moment of enlightenment, Congress has recognized that citizens of states with an income tax get an in-effect federal tax subsidy through the allowance of an itemized deduction for state income taxes paid. Those of us in states with no state income tax (but correspondingly higher sales taxes) get nothing. So the Act allows taxpayers the choice: to deduct one or the other. For us in Washington, that obviously means the sales tax we pay comes back as an itemized deduction. As was the case with the old law, taxpayers can either keep track of sales tax actually paid (easier today with consumer finance programs like Quicken) or use a table amount based on income. And there apparently will be a bit of a hybrid approach allowed—the table amount plus the tax on certain large purchases to be described in regulations. But, just like the state income tax, the sales tax deduction is not an eligible deduction for purposes of computing the alternative minimum tax (AMT).

The IRS will have to scramble to get sales tax tables published in time for the 2004 tax season. It is likely that most of our clients will not be terribly impressed with the deduction afforded by the sales tax tables. So it might be a good idea to go back through monthly expenditures for items on which sales tax is paid, paying special attention to big ticket items. In Washington, you pay sales tax on just about everything you buy except the following:

- Grocery items
- Pharmaceuticals and medical care
- Services (such as our fees, legal and investment fees, etc.)
- Airfare
- Gasoline (the taxes on gas are not sales taxes)
- Utilities

The deduction effectively makes the cost of buying a car and other large purchases 3% cheaper (the maximum ordinary rate times Washington's sales tax rate of almost 9%). But act soon: like just about every tax benefit Congress bestows lately, this deduction is good only for '04 and '05.

For clients in Oregon and California, in all likelihood you needn't bother—your state income

tax deduction will easily end up the bigger of the two.

On the subject of AMT . . .

The Act again punted on the much-needed and long-overdue reform of the alternative minimum tax system. Moderate increases in exemption amounts (which will do our clients little good) were all that were offered. On the subject of the AMT, we came across a study recently which predicts that ***nearly 80% of middle income or above taxpayers will be in the AMT by the year 2008.*** If this holds true, and we have no reason to doubt it, the AMT will, in effect, become the *de facto* tax system in the country.

Rules tighten on deferred compensation arrangements

Most public companies and many large private companies have plans allowing key employees to defer the payout of regular or incentive and bonus compensation. These plans are all premised on fairly longstanding common law (the doctrine of constructive receipt) and statutory (Sections 83, 402, 451, 280G) rules which allow the deferral of income tax consequences on otherwise vested compensation until the time of eventual payment by the employer. Social Security taxes, however, are imposed at the time the compensation is no longer subject to a substantial risk of forfeiture.

The principal benefit of such arrangements is to allow executives and other key employees the flexibility to defer taking pay which is over and above their current spending needs. The plans can also allow executives and other participants to put substantially more money away for retirement than the current limits on ERISA-type plans allow. Deferred amounts are invested by the company or accrue earnings under the plan and compound on a pre-tax basis (e.g., $100 of deferred compensation will accrue investment earnings and compound on the full $100 earned, whereas taxable compensation is immediately reduced by taxes to $65, and the earnings on taxable compensation are also currently taxable).

The principal concerns of the executive in entering into such deferral arrangements include:

- If the company becomes insolvent, how safe is the deferral?
- What happens if the company is taken over, or new board members have a change of heart?
- What if I need the money sooner?
- Can I re-defer an amount previously deferred for an even longer period?

Not surprisingly, the tax law mandates that deferred amounts must remain subject to the risk of creditors of the company, i.e., you can't completely safeguard the money, lest the funds become taxable currently. Additionally, too much flexibility regarding payouts—the ability to change your mind—result in constructive receipt of monies otherwise vested (not subject to any service or performance requirement).

Many such arrangements are funded into so-called "Rabbi Trusts" which are designed to protect the executive from subsequent board action to abrogate the terms of an existing plan. But under the tax law, such trust assets must remain subject to the risk of the company's creditors.

As with virtually every provision of tax law, planners and taxpayers try to push the envelope and develop workarounds. The 2004 Tax Act closes off some of those strategies, effectively clarifying (or re-clarifying) longer-standing provisions of the law. There is no new groundbreaking here; just a few additional rules to follow to gain deferral of otherwise vested compensation for tax purposes.

Under the Act, distributions from a nonqualified deferred compensation plan may only be made upon:

- A separation from service
- Death or disability
- A change in control (the definition of such is to be defined by Regulations, and may parallel but be somewhat more restrictive than the "golden parachute" rules under Section 280G)
- The occurrence of an unforeseen emergency
- A specified time or upon a specified schedule

For certain "key employees" of public companies, distributions based on separation from service may not be made earlier than six months following the date of separation.

Additionally, plan assets funded in offshore trusts (designed to make the monies harder for creditors of the company to reach) are now viewed as "constructively received" by the employee and therefore currently taxed.

An "unforeseen emergency" is defined as a "severe financial hardship to the participant, participant's spouse or dependent, resulting from sudden and unexpected illness; loss of the participant's property due to casualty, or other similar extraordinary or unforeseeable circumstances arising from events beyond the participant's control." An example of the latter might be a court-ordered property division pursuant to divorce or legal separation. In addition, the amount of the distribution may not exceed the amount (after considering taxes on the payout) necessary to satisfy the emergency, and must take into account insurance and other financial resources available to the employee.

No other accelerations of distributions may be allowed by the plan (except as may be

provided in future regulations). For example, a change in the form of the distribution from an annuity to a lump sum payment is not permitted. However, the plan may allow for withholding for social security taxes to be made from the employee's interest in the plan, as well as income taxes on certain vesting events.

The Act requires that the plan must provide that compensation for services performed during the tax year may be deferred at the participant's election only if the election is made before the close of the preceding year or at such earlier time as may be provided in regulations. The Act suggests that regulations may provide that elections to defer bonuses earned over several years may be made after the beginning of the service period, as long as the election is made prior to 12 months before the commencement of the earliest payout. In the case of "performance-based compensation" attributable to service performed over a period of at least one year, the election may be made no later than six months prior to the end of the service period.

- Performance-based compensation must be "variable and contingent on the satisfaction of certain organizational or individual performance criteria, and not readily ascertainable at the time of the election"

Under the Act, a plan may allow for changes in the time and form of payouts (i.e., re-deferrals) subject to the following:

- The plan requires that such new election cannot be effective for at least 12 months
- Except in the case of death, disability, unforeseen circumstances, etc., the plan requires that any additional deferral under a new election be made for at least five additional years
- The plan requires that any election based upon a specified time be made at least 12 months prior to the date of the first payment

The rules expressly do ***not*** govern nonqualified stock options where the exercise price is not less than fair market value on the date of grant, nor does it affect the treatment of incentive stock options. The act also does not apply to compensation earned by year-end and paid within two-and-a-half months of the succeeding year.

A "nonqualified deferred compensation plan" is defined as any plan that provides for the deferral of compensation ***other than*** a qualified employer plan (ERISA plan, tax-sheltered annuity plan, eligible Section 457 plan), or a bona fide vacation, sick leave, disability or death benefit plan. The Act also appears to cover similar arrangements other than between an employer and employee.

Finally, the Act requires W-2 reporting (for information purposes) of amounts deferred during the year. The provisions are effective for deferrals beginning after December 31, 2004. Amounts deferred prior to 2005 are subject to the Act if the plan is materially modified after October 3, 2004.

Manufacturing tax deduction

The main impetus for the Act (before all the political add-ons) was to stem international controversy over the foreign sales corporation/extraterritorial income (FSC/ETI) tax benefits for US exporters (the tax breaks allow for exclusions from income for qualifying exports). The World Trade Organization had declared the FSC/ETI regime an illegal trade subsidy four years ago, and the European Union recently slapped sanctions on US exporters. Consequently, US manufacturers and exporters have been advocating for repeal.

The new legislation gradually phases out the FSC/ETI system and replaces it with a deduction for domestic manufacturing phasing in over 5 years beginning in 2005. Easily the most costly provision of the new law, the deduction will effectively reduce the maximum tax rate on manufacturing income from 35% to 32%.

The good news is that lawmakers have defined domestic "manufacturing" very broadly to include most non-retailing activities, including construction and renovation of residential and commercial buildings in the US, software development and film production, electricity generation (but not transmission), gas and water production (but not transmission), and growing crops, plants and trees in the US. The term even includes engineering or architectural services performed in the US for construction projects located in the US. Only restaurants appear to be left out (the Conference Agreement interestingly relates an example of a coffee roaster (a qualifying activity) using its beans in coffee-making in its own retail stores (nonqualifying).

The deduction is equal to a percentage of the lesser of a taxpayer's "qualified production activities income" or taxable income for the year. The percentage is:

- 3% in tax years beginning in 2005 and 2006
- 6% in tax years beginning in 2007 through 2009
- 9% thereafter

However, the deduction is further limited to 50% of the wages paid during the calendar year hat ends in such tax year.

The deduction multiplied by the maximum rate on corporate and personal income of 35% equates to an effective lowering of the tax rate on manufacturing income to 32% once fully phased in. The deduction is also good for the AMT.

Specifically, “qualified production activities income” is equal to “domestic production receipts” reduced by the sum of:

- The costs of goods sold that are allocable to such receipts (determined generally under the current inventory capitalization rules of Section 263A)
- Other deductions, expenses or losses that are directly allocable to such receipts (e.g., selling and marketing expenses), and
- A proper share of other deductions, expenses and losses not directly allocable to any class of income (e.g., G&A costs)

“Domestic Production Gross Receipts” are gross receipts derived from a sale or other disposition, or from any lease, rental or licensing of property manufactured, produced, grown or extracted in whole or significant part within the US.

For affiliated groups of corporations, the limitations are applied as if the group were a single taxpayer and allocated in proportion to each member’s qualified production activities income.

With respect to S corporations, partnerships or LLCs, things are a bit more complicated.

The wage limitation is applied first at the entity level, while the deduction is determined at the partner, member or shareholder level, taking into account that owner’s proportionate share of the qualified production activities income of the entity.

If the owner is a passive investor, things get messier still. If it is the owner’s only qualifying activity, the income limitation effectively provides clearance under the passive loss and at-risk rules. However, if the owner has other passive activities generating offsetting losses, the effect may be that the manufacturer’s deduction is deferred (by reducing the passive income from the manufacturing activity, other passive losses are utilized to a lesser extent and carry over).

All things considered, the deduction is very beneficial. But look forward to reams of tax regulations interpreting these provisions and considerable complexity in performing the additional tax accounting necessary in tax returns.

One more year added to increased small business expensing

Two years ago, Congress raised the threshold for small business current expensing of equipment purchases from $25,000 to $100,000 (reduced when the cost of qualifying property placed in service in a given tax year exceeds $400,000). The measure was designed as a temporary economic stimulus and was set to expire in 2006. It has now been extended through 2007, and both the expense amount and the property cap are indexed for inflation. Thus, for 2004, the expense amount is now $102,000 and the cap is increased to $410,000.

The “SUV” deduction

A provision (loophole?) in the tax law that generated more taxpayer interest than most in memory was the one that allowed a current write-off for the full cost of large SUVs (more than 6,000 pounds). Of course, the write-off had to be factored down by the percentage of business versus personal use. There was so much publicity that it was all but assured that Congress would repeal or limit what many viewed as a mistake in the law. Well, they have. The ’04 Act caps the deduction at $25,000 for rigs not weighing more than 14,000 pounds, effective for property “placed in service” (in a business use) after the date of enactment. Owners of big SUVs still fare better than other vehicle owners, however. Vehicles under 6,000 pounds are currently capped at $2,960, plus bonus depreciation (which expires this year).

Faster recovery of leasehold improvements

The Act provides for a 15-year write-off of qualified leasehold improvements to nonresidential real property placed in service after the date of enactment and before 2006. The prior recovery period was 39 years (which is obviously astonishingly long) or the date the improvements were demolished/abandoned (for example, in connection with leasing the improved property to a new tenant). If the improvement is made by the lessor, a subsequent owner cannot piggy-back on the 15-year period to depreciate the improvement.

A qualified leasehold improvement is an improvement to the interior of a building, made by either the lessor or lessee and placed in service more than three years after the building itself was first placed in service.

The law also provides for 15-year straight-line recovery for qualified restaurant property placed in service before 2006. Such property consists of building improvements placed in service more than three years after the building is placed in service.

Of course, a cost segregation study can identify restaurant or building improvement costs that qualify as tangible personal property, and therefore depreciable over even shorter five- or seven-year lives.

S corporation reform

The somewhat draconian S corporation rules have been relaxed again. Specifically:

- The number of permitted shareholders is increased from 75 to 100
- All members of a family (defined as the common ancestor, spouse and lineal descendants and spouses of the same) are now treated as a single shareholder
- The law now allows the transfer of suspended losses (from basis limitations) to a spouse incident to divorce
- The Act gives relief from inadvertent invalid S corporation elections and terminations

We still strongly prefer forming LLCs over S corporations, for a number of reasons. Both entity forms enjoy the same liability limitations protecting owners from debts and judgment creditors of the entity. However, LLCs are still far more flexible in operation from a tax law standpoint. Owners of an LLC also get regular tax basis (but not "at risk" tax basis) for the debts of an LLC. And LLCs, unlike S corporations, can create more complicated capital structures (preferential distributions, tiered distributions, special allocations, etc.). Finally, property contributed to an S corporation generally must stay there. If appreciated property is taken out of an S corporation, it receives "deemed sale" treatment under the tax law.

A "too good to be true" tax deal for private aircraft goes away

The new law closes off an amazingly good benefit to holding private aircraft in S corporations otherwise engaged in a trade or business. Personal use of the aircraft by employee-owners could constitute business use, thereby allowing for depreciation and deduction of operating costs, if income attributable to the personal use was "imputed" to the employee-owner under so-called SIFL rates. The benefit stemmed from the fact that the deductions passing through to the owner greatly exceeded the income reported under the SIFL rates, resulting in a large net deduction (in effect, greatly lowering the after-tax cost of owning the plane). The Act effectively overrules a case upon which the technique was based.

A few charitable deduction provisions

Congress' recognition of the growing abuses from inflating the value of cars donated to charity has put an end to that practice. If the charity re-sells the vehicle without using it in any significant way (as most assuredly do), then the value of the charitable deduction cannot exceed what the charity ultimately fetches for the car. Blue book value deductions are out.

On the plus side, the law now allows for greater contribution deductions for gifts of a patent or other intellectual property (other than copyrights). The initial deduction is limited to the taxpayer's basis in the property (typically zero). However, the donor is now allowed to take an additional deduction based on a specified percentage of the income the donee receives from the donated property.

International taxes

Congress somewhat simplified the foreign tax credit computations, reducing the number of foreign income "baskets" from nine to two and providing for other changes. The Act also creates a 10-year carryover and one-year carryback for unused foreign tax credits and eliminates the 90% limit for the AMT foreign tax credit. The law also makes changes and simplifications to the Subpart F rules.

Tax shelter rules

The Act again tightens the abusive tax shelter noose, by increasing penalties for failure to disclose reportable transactions and listed transactions and toughening sanctions on "material advisors" and promoters. The latter must maintain investor lists or face penalties.

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